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Congressman Ron Paul
Statement for the Record

One of the most enduring myths in the United States is that this country has a free market, when in fact nothing could be further from the truth. In reality, government has pervaded so many aspects of the market that what we see as a free market is merely the structural shell of formerly free institutions, while government pulls the strings behind the scenes. No better illustration of this can be found than in the Federal Reserve's manipulation of interest rates.

The Fed has interfered with the proper functioning of interest rates for decades, but perhaps never as boldly as it has in the past few years through its policies of quantitative easing. In Chairman Bernanke's most recent press conference he stated that the Fed wishes not only to drive down rates on Treasury debt, but also rates on mortgages, corporate bonds, and other important interest rates. Markets greeted this statement enthusiastically, as they realize that this means trillions more newly-created dollars flowing directly to Wall Street.

What almost no one realizes, however, is that interest rates are a price, the price of money. Like any other price, interest rates perform both a signaling and a coordination function. Interest rates coordinate the actions of savers and borrowers: higher interest rates attract savers, lower interest rates attract borrowers, and the market interest rate provides an equilibrium between saving and borrowing. The interest rate also signals the availability of funds: lower interest rates signal an abundance of loanable funds, while high interest rates signal a paucity of funds. As interest rates rise, more people save and fewer people borrow; as interest rates fall, fewer people save and more people borrow. Lower interest rates also tend to favor longer-term, more capital-intensive projects. Projects which might not be profitable at eight percent interest rate may suddenly become profitable if the interest rate drops to three percent.

In order to lower the interest rate, more loanable funds must be available. But if individual saving habits remain unchanged, the only way to lower interest rates is to inject additional money or credit into the financial system. This new injection of credit, which has its origins not in savings but merely through a new bank balance sheet entry, results in a lowering of the rate of interest. The lower rate of interest signals the availability of additional loanable funds, which spurs additional borrowing. These borrowed funds are then put to use to fund capital projects. Additionally, as the interest rate lowers some savers may judge that their funds are now better off being used to fund present consumption, rather than continuing to be saved for future consumption.

Because the interest rate is the price of money, manipulation of interest rates has the same effect in the market for loanable funds as price controls have in markets for goods and services. Since demand for funds has increased, but the supply is not being increased by the market, the only way to match the shortfall is to continue to create new credit. But this process cannot continue indefinitely. At some point the capital projects funded by the new credit are completed. Houses must be sold, mines must begin to produce ore, factories must begin to operate and produce consumer goods.

But because consumption patterns have either remained unchanged or have become more present-oriented, by the time these new capital projects are finished and begin to produce, the producers find no market for their goods. Because the coordination between savings and consumption was severed through the artificial lowering of the interest rate, both savers and borrowers have been signaled into unsustainable patterns of economic activity. Resources that would have been used in productive endeavors under a regime of market-determined interest rates are instead shuttled into endeavors that only after the fact are determined to be unprofitable. In order to return to a functioning economy, those resources which have been malinvested need to be liquidated and shifted into sectors in which they can be put to productive use.

Another effect of the injections of credit into the system is that prices rise. Because credit functions as money, the effect of creating new credit is the same as printing new money. More money chasing the same amount of goods results in a rise in prices. And that rise in prices affects different groups of people in different ways. Wall Street always is the first to benefit from the new credit, because it is injected by the Fed directly into the financial system. From there it trickles down through the economy, but Wall Street and the banking system gain the use of the new credit before prices rise. Main Street, however, sees the prices rise before they are able to take advantage of the newly-created credit. The purchasing power of the dollar is eroded and the standard of living of the American people drops.

We live today not in a free market economic system but in a "mixed economy", marked by an uneasy mixture of corporatism; vestiges of free market capitalism; and outright central planning in some sectors. The folly of central planning that should have been learned after the fall of the Soviet Union never took hold in Washington. Each infusion of credit by the Fed distorts the structure of the economy, damages the important role that interest rates play in the market, and erodes the purchasing power of the dollar. Markets see the interest rate and assume that the price is functioning as it should, when in fact it is being manipulated by a select few bureaucrats in Washington. Fed policymakers view themselves as wise gurus managing the economy, yet every action they take results in economic distortion and devastation.

The concept of the free market suffers as a result, since markets see a façade of market-determined prices as well as the reality of economic crisis. Wall Street makes out like bandits, while Main Street continues to suffer. The negative effects of manipulated interest rates are readily apparent in the economic malaise we are suffering now, but the real cause of this crisis, the Fed's centrally planned mismanagement, remains artfully concealed. Unless Congress gets serious about reining in the Federal Reserve and putting an end to its manipulation, the economic distortions the Fed has caused will not be liquidated; they will become more entrenched, keeping true economic recovery out of our grasp and sowing the seeds for future crisis.